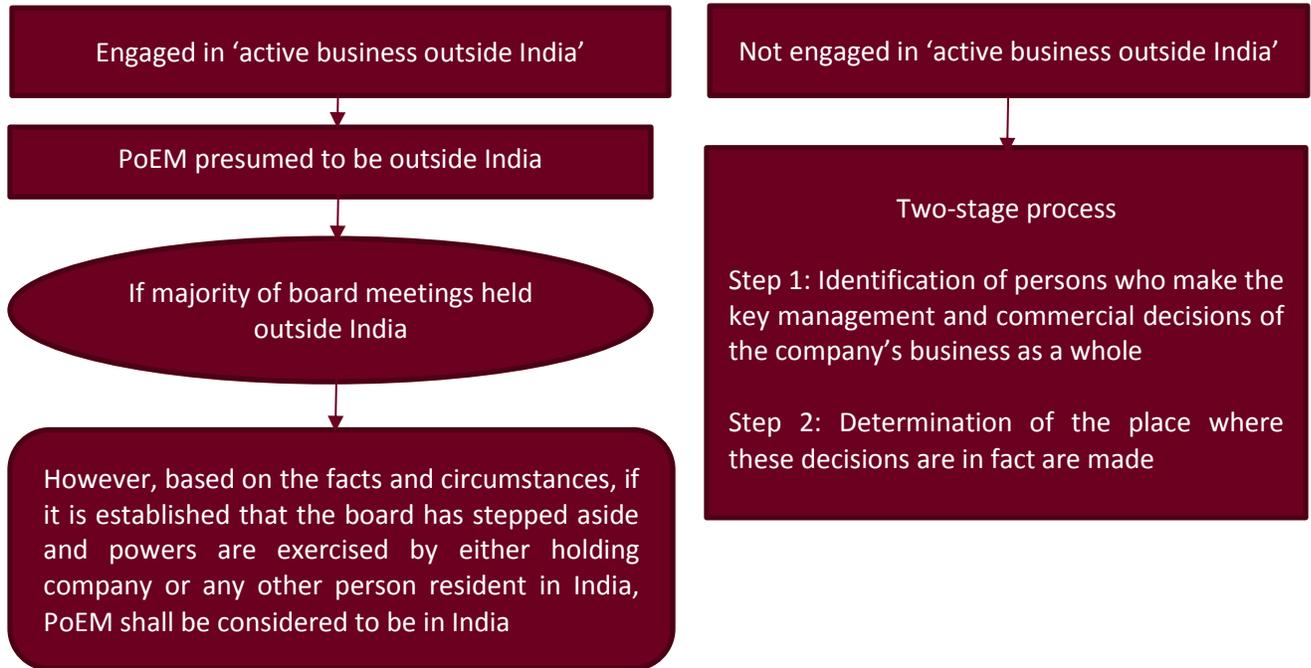


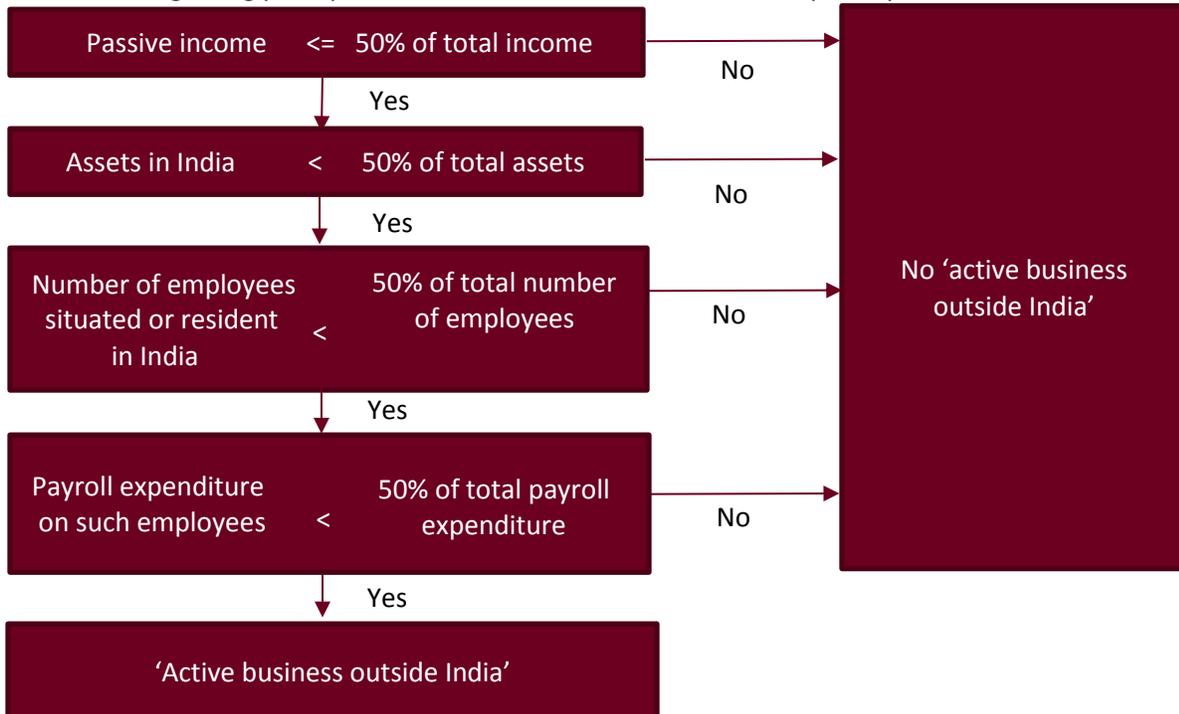
Guiding principles for determination of Place of Effective Management ('PoEM') of a company

1. Key highlights

1.1 PoEM of a company shall depend on the place where the company is engaged in active business and conduct of the board of the entity.



1.2 In order to analyze whether or not the company is engaged in 'active business outside India', the guiding principles have laid down the tests have been portrayed as follows:



The final guidelines have further provided provided an explanation as to:

- which total income will be taken into consideration for the above test;
- the computation of the total assets which are to be taken into consideration for the above test;
- the number of employees to be considered for the above test;
- the computation of the term 'payroll' as mentioned in the above test; &
- the sources of income to be included in the term 'passive income' – which are income from purchase/sale of goods from/to the company's associated enterprise and income by way of royalty, dividend, capital gains, interest or rental income. The final guidelines clarify that for a banking company or public financial institution (*provided their activities are regulated*), the interest received shall not be considered as a passive income.

1.3 The guidelines have defined certain words and phrases for a better understanding in respect of determining the PoEM of a company:

- Place of effective management is defined to mean a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance, made;
- Passive income of an entity is defined as the aggregate of:
 - income from transactions where both purchase and sale of goods is from/to its associated enterprises; and
 - income by way of royalty, dividend, capital gains, interest or rental income.
- The head office of a company would be the place where the company's senior management and their direct support staff are located or, if they are located at more than one location, the place where they are primarily or predominantly located; &
- The senior management in respect of a company would mean the person or persons who are generally responsible for developing and formulating key strategies and policies for the company and for ensuring or overseeing the execution and implementation of those strategies on a regular and on-going basis.

1.4 In case where the company is not engaged in 'active business outside India', the determination of PoEM would be a two-stage process as depicted above. The guidelines provide for the following factors/parameters which shall be taken into account for determining PoEM in such cases:

- The location where a company's board regularly meets and makes decisions may be the company's place of effective management provided,
 - the board retains and exercises its authority to govern the company; &
 - does, in substance, make the key management and commercial decisions necessary for the conduct of the company's business as a whole.
- In cases where the board has delegated its authority to committee/s, the location where the members of such committee/s formulate the key strategies, shall be of relevance for the determination of PoEM;
- In case of circular resolution or round robin voting the factors like, the frequency with which it is used, the type of decisions made in that manner and where the parties involved in those decisions are located etc. are to be considered;
- The location of the company's head office since it often represents the place where the key decisions of the company are made;
- Day to day routine operational decisions shall not be relevant for determination of PoEM;

- The involvement of the shareholders to the extent mandated by company laws shall bear no relevance in the determination of PoEM; &
 - Secondary factors like place where main and substantial activity of the company is carried out or place where the accounting records of the company are kept shall also be taken into consideration.
- 1.5 Certain principles which have to be kept in mind while determining the PoEM of a company, which are essentially the crux of the matter, have been listed down hereunder:
- Any determination of the PoEM will depend upon the facts and circumstances of a given case. The principles as laid down for determining the PoEM are for guidance only. No single principle will be decisive in itself;
 - Since 'residence' is to be determined for each year, PoEM will also be required to be determined on year to year basis;
 - The actual conduct and activities performed by the company over a period of time, during the previous year, need to be considered. In other words, a 'snapshot' approach is not to be adopted;
 - *De facto* decisions shall prevail over *de jure* decisions; &
 - If it is determined that PoEM is in India as well as outside India, then PoEM shall be presumed to be in India if it has been mainly/predominantly in India.
- 1.6 The guidelines at various instances stress upon the fact that the exercise of determination of PoEM is circumstantial and depends on the facts of each case. The following points listed in the guidelines are important in this regard:
- The following shall not be a conclusive evidence of the existence of PoEM of a foreign company in India:
 - Foreign company being completely owned by an Indian company;
 - Existence of Permanent Establishment ('PE') of a foreign entity in India;
 - Residence of directors of the foreign company in India;
 - Presence of local management in India in respect of activities carried out by a foreign company in India; &
 - Existence in India of support functions that are preparatory and auxiliary in character.
- 1.7 In order to explicitly clarify the interpretation and application of such principles, the CBDT has provided illustrations, that highlight the fact driven and circumstantial nature of the exercise to determine the PoEM.
- 1.8 The substantial additions/alterations to the final guidelines vis-à-vis the draft guidelines have been highlighted as follows:
- In relation to the tests laid down to analyze whether an entity is engaged in 'active business outside India', the final guidelines have elaborated on and defined the key terms used in the said tests;
 - In reference to the definition of passive income, the guidelines have clarified that any income by way of interest shall not be considered to be passive income in case of a company which is engaged in the business of banking or is a public financial institution, and its activities are regulated as such under the applicable laws of the country of incorporation;
 - The PoEM in case of a company engaged in 'active business outside India' shall be presumed to be outside India if the majority meetings of the board of directors of the

company are held outside India. However, if the BOD stands aside and does not exercise its powers, and such powers are instead exercised by the parent company or any other person resident in India, the PoEM shall be considered to be in India. In this regard, it has been clearly stated that in case the Board of Directors ('BOD') follow the general and objective principles laid down by the parent entity in respect of all its global companies, and that are not specific to one entity, it shall not be constituted as a case of the BOD standing aside;

- In order to determine whether the conditions for a company as engaged in 'active business outside India' are satisfied or not, the guiding principles state that the average of the data of the previous year and two years prior to that shall be taken into account. In case the company has been in existence for a shorter period, then data of such period shall be considered. It has been clarified that where the accounting year for tax purposes, in accordance with laws of country of incorporation of the company, is different from the previous year, then, data of the accounting year that ends during the relevant previous year and two accounting years preceding it shall be considered;
- For the determination of PoEM in case of circular resolution or round robin voting the factors like, the frequency with which it is used, the type of decisions made in that manner and where the parties involved in those decisions are located etc. are to be considered;
- When analyzing whether the decisions made by the shareholders are relevant for the determination of PoEM, it is stated that decisions made by the shareholders on matters which are reserved for shareholder decision under the company laws shall not be relevant. However, in case the involvement of the shareholders affects the key commercial and management decision making of the company, the same shall prove to be relevant for the determination of PoEM. Whether the shareholder involvement is crossing the line into that of effective management is one of fact and has to be determined on case-to-case basis only;
- The final guidelines have elaborated on the fact that day-to-day operational activities performed by the middle and lower level management shall not be relevant for the determination of PoEM. For the determination of PoEM, the key commercial and management decisions are of due importance. In a case where the person responsible for operational decision is the same person who is responsible for the key management and commercial decision, it will be necessary to distinguish the two type of decisions and thereafter assess the location where the key management and commercial decisions are taken;
- The final guidelines clearly state that the Assessing Officer ('AO') shall prior to the initiation of proceedings for holding a company incorporated outside India as a resident of India on the basis of PoEM provisions, seek approval of the Principal Commissioner or the Commissioner, as the case may be; &
- It has been clarified that mere existence of a PE of a foreign entity in India shall not be a conclusive evidence for the foreign entity to have its PoEM in India.

1.9 The CBDT via the Press Release dated January 24, 2017 has clarified the following points:

- The intent is not to target Indian multinationals which are engaged in business activity outside India. The intent is to target shell companies and companies which are created for retaining income outside India although real control and management of affairs is located in India; &

- The said guidelines for determination of PoEM shall not apply to companies having turnover or gross receipts of INR 50 crores or less in a financial year.

2. KNAV comments

- 2.1 The guiding principles issued by CBDT are welcomed and provide clarification with respect to a lot of ambiguous and contentious aspects which lacked clarity in the draft guiding principles.
- 2.2 The intention of the legislature has been clearly brought out in the language of the guiding principles - to target shell companies that intend to evade tax in India. This is also corroborated by the intention which has been clearly spelt out in the press release. It has also been explicitly stated that the guidelines do not aim at Indian multinationals that are substantially engaged in business activity outside India.
- 2.3 It would be interesting to see the approach and the stand which would be taken by the revenue authorities in cases where the quantitative thresholds, being the tests for fulfilling the 'active business outside India' criteria are met. Merely because they meet the quantitative thresholds are met, one cannot with absolute certainty, content that the PoEM of such companies is not in India. It is advisable to not only meet the quantitative thresholds, but also that the actual conduct backed by corroborative documentation is put in place.
- 2.4 It would not be out of place to reiterate again that the process of determination of PoEM is a factual one and the one that is driven by substance over form. It is imperative to demonstrate the 'place' where the decisions are, in substance, taken and to identify the persons actually driving the decision-making process.
- 2.5 In order to avoid unwarranted litigation, the guiding principles have incorporated adequate administrative safeguards whereby, not only before proposing to hold a company as a resident of India on the basis of PoEM provisions, but also before initiating any such proceedings, the AO is mandated to seek an approval. This ensures a two-stage check within the department and one would earnestly hope that these checks are judiciously performed.
- 2.6 Although the guiding principles provide clarity on several aspects, there is still a lot of ambiguity on certain matters. Few of them are stated as under:
 - The term used in first limb of definition of passive income includes income from the transactions where both the purchase and sale of goods is from/to its associated enterprises. It would require clarification whether the word 'goods' used here would mean only goods or would be deemed to include services.
 - In relation to the second condition stated for 'active business outside India' whereby not less than 50% of total number of employees should be situated or resident in India, the guidelines seek to clarify that the employees to be considered for the above purpose shall include persons, who though not employed directly by the company, perform tasks similar to those performed by the employees. Again, there may be divergent views on whether a contractual employee, representative agent, professional employer organization, etc. are intended to be covered or not.
 - The said guiding principles are for the determination of PoEM for a company. However, it would be interesting to see if they also bare some relevance and significance in case of structures set up in a non-corporate form, e.g. a partnership firm.
 - The press release clarifies that the said guidelines for determination of PoEM shall not apply to companies having turnover or gross receipts of INR 50 crores or less in a financial

year. It would require clarification whether the said turnover to be considered is of the company under consideration or the consolidated turnover of all the group entities. The view that stakeholders are likely to resort to, is that since each entity has to be examined separately as stated in the example 5 of the guiding principles, the turnover here refers to each entity's individual turnover.

- 2.7 Considering the massive implications which may arise if an entity's PoEM is regarded to be in India as also the aspects covered by the final guiding principles, one can say with certainty that the CBDT shall in the near future come out with further clarifications in the form of guidelines/FAQ's.